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In the Supreme Court of the United States

OCTOBER TERM, 1967

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IRVING GORDON AND MARGARET GORDON

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in the above-entitled case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4-52)<sup>1</sup> are reported at 45 T.C. 71. The opinion of the Court of Appeals (App. A, *infra*, pp. 9-39) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on July 26, 1967 (App. B, *infra*, p. 41). The juris-

<sup>1</sup> "R." references are to the separately bound Appendix B to the Commissioner's Brief in the Court of Appeals.

diction of this Court is invoked under 28 U.S.C. 1254(1).

**QUESTIONS PRESENTED**

In 1961, a company transferred part of its operating assets and cash to a newly formed corporation in exchange for all the stock and a demand note of the new company. Then, in the same year, it issued to its own stockholders transferable rights to purchase at \$16 per share 57 percent of the stock of the new corporation, which stock then had a fair market value of over \$26 per share. It disposed of the remaining 43 percent in 1963 through a similar issuance of rights. The questions presented here relate to the 1961 tax liability of respondents, stockholders of the company, who exercised some and sold others of the rights they received in that year. Those questions are:

1. Whether the 1961 transaction qualified for the nonrecognition of gain that Section 355 affords to some corporate spinoffs, in which event respondents would not be required to report gain with respect to the rights they exercised.
2. Whether the gain respondents realized upon the rights they sold was capital in nature or a dividend taxable as ordinary income.

**STATUTE INVOLVED**

Section 355 of the Internal Revenue Code of 1954 appears in Appendix C, *infra*, pp. 43-46.

**STATEMENT**

In accordance with a plan approved by its stockholders in March 1961, Pacific Telephone and Tele-

graph Company (Pacific) separated the businesses it then conducted in Oregon, Washington and Idaho from its California operations. Pacific transferred its non-California assets and liabilities and \$110,000 cash to a newly-formed corporation, Pacific Northwest Bell Telephone Company (Northwest). Pacific received in exchange all 30,460,000 shares of Northwest's common stock and a \$200,000,000 demand note. That exchange was accomplished by June 30, 1961 (App. A, *infra*, pp. 11, 15).

The plan further provided that all of the Northwest stock ultimately would be sold to Pacific's stockholders. Left to the discretion of Pacific's management were such questions as the number and timing of offerings and the price to be paid for Northwest stock. Those management decisions were to be made in response to the capital requirements of Pacific, although it was anticipated that all of the Northwest stock would be disposed of within three years (App. A, *infra*, p. 15).

On September 20, 1961, Pacific issued to its stockholders one transferable stock right for each outstanding share of Pacific stock. Six of these rights and a payment of \$16 were required to purchase one share of Northwest stock. At that time, the fair market value of the Northwest stock was \$26 per share. The rights were sufficient to purchase approximately 57 percent of the Northwest stock. On June 12, 1963, the remaining 43 percent was offered on terms which required eight rights and payment of \$16 to acquire one share of Northwest stock (App. A, *infra*, pp. 15-16).

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Respondents are stockholders of Pacific who received 1,540 stock rights in 1961. They sold four rights for a total price of \$6.36, reporting that amount as long-term capital gain. They exercised the remaining rights, as to which they reported no income (App. A, *infra*, pp. 10, 16).

The Commissioner issued a notice of proposed deficiency on the basis that, with respect to the rights which were exercised, respondents received a dividend taxable at ordinary income rates, measured by the difference between the fair market value of \$26 and the \$16 price of each share of Northwest stock, and that, with respect to the rights sold, respondents received income taxable at ordinary income rates in the amount of the fair market value of the rights (App. A, *infra*, p. 16).

In a suit for a redetermination, the Tax Court held that the basic transaction here qualified for tax-free treatment under Section 355 of the 1954 Code (R. 35-50). The Tax Court further held, however, that the gain realized on the sale of the four stock rights was taxable as a dividend (R. 50-52).

The Second Circuit, Judge Friendly dissenting, agreed that the receipt and exercise of the stock rights qualified for nonrecognition of gain under Section 355, but concluded that the gain realized on the sale of the rights was taxable only as capital gain (App. A, *infra*, pp. 29, 30-31).

#### **REASONS FOR GRANTING THE WRIT**

There is a direct conflict between the Second Circuit's decision in this case and the Ninth Circuit's

decision in *Commissioner v. Baan* (decided July 7, 1967, 67-2 U.S.T.C., para. 9556). The Baans are other stockholders of Pacific who have litigated the tax consequences of their receipt and exercise of rights in 1961. Since the two cases grew out of the same transaction, they were tried and decided together in the Tax Court. Shortly before the Second Circuit handed down its opinion affirming the Tax Court's holding that the transaction at issue qualified as a nontaxable spinoff under Section 355, the Ninth Circuit, which had jurisdiction of the *Baan* case on appeal, reversed the Tax Court on the same point.

The Ninth Circuit ruled that because the stock rights were transferable and exercise required the payment of \$16 for each share of Northwest stock purchased, there had not been a distribution of "solely stock or securities" of Northwest "with respect to [Pacific's] \* \* \* stock," as required by Section 355(a) (1) (A). As an additional independent ground for its decision, the Ninth Circuit, as did Judge Friendly in dissent in the present case, found that Pacific's disposition of only 57 percent of the Northwest stock in 1961, while retaining the other 43 percent until 1963, did not meet the standard of Section 355(a)(1)(D), which permits nonrecognition of gain only if there is a distribution of "all of the stock and securities in the controlled corporation"—here Northwest—that Pacific "held \* \* \* immediately before the distribution," or, in the alternative, a distribution of "an amount of stock \* \* \* constituting 'control' within the meaning of Section 368(c)," i.e., at least 80 percent of the Northwest stock.

The majority of the Second Circuit, however, disregarded the fact that the stock rights were marketable, and treated the cash consideration merely as a capital contribution that did not bar characterization of the entire transaction as a tax-free spinoff. Pacific's 1961 and 1963 offerings were viewed as part of a single transaction by which it "distributed" 100 percent of the Northwest stock, notwithstanding that as of the time of the 1961 offering no final decision had been made or obligation incurred as to whether or when the remainder of the Northwest stock would be offered. In fact, this occurred nearly two years later.

The Ninth Circuit did not have before it the issue of whether the gain realized by Pacific's stockholders who sold rights represented capital gain or dividend income, and therefore its decision technically is not in conflict with that part of the Second Circuit's decision here. Nevertheless, the result in the Second Circuit—that the gain upon sale was capital in nature—was predicated on its holding that the overall transaction qualified under Section 355, so that, in the Second Circuit's view, the two issues were interconnected. Furthermore, the tax liabilities of 2,099 Pacific stockholders have been in abeyance pending the outcome of this litigation, and some will have sold rights. We therefore submit that if certiorari is granted, this Court's review should encompass both questions presented in order that there may be a more complete disposition of the controversy.

In sum, two courts of appeals have adopted quite different approaches to the proper interpretation of a

statutory provision that grants nonrecognition treatment to certain spinoffs. Those courts have consequently reached diametrically opposite conclusions in their consideration of the tax consequences of one transaction. The divergent results prevent the Commissioner from uniformly taxing more than 2,000 Pacific shareholders. In these circumstances review by this Court is plainly warranted.

**CONCLUSION**

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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